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INTRODUCTION

Is the ketchup that President Bill Clinton pours over his french fries and Big Mac™[1] American? Not for purposes of the North American Free Trade Agreement.[2] According to NAFTA's rules of origin,[3] for ketchup to fit within the definition of "North American" and, thereby,

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1. *See* Amy Wallace, *American Culture on a Bun*, L.A. Times, Dec. 30, 1993, at A1 (discussing the anniversary of the Big Mac™ and recounting, "[a]nyone who says Clinton doesn't inhale . . . never saw him around a Big Mac™").

2. North America Free Trade Agreement, Dec. 17, 1992, *reprinted in* 32 I.L.M. 296 (entered into force Jan. 1, 1994) [hereinafter NAFTA]. For a discussion of the ratification process, *see* Jane Bussey, *Pact's Effect Wouldn't Be Felt Instantly; Plan Calls for Barriers to be Slowly Phased Out*, Miami Herald, Oct. 18, 1993, at 9A.

The parties to NAFTA developed the agreement in accordance with Article XXIV of the General Agreement on Tariffs and Trade ("GATT") which defines and allows free trade agreements. *See* General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A3, 555 U.N.T.S. 187, art. XXIV 8(a)-(b) [hereinafter GATT]; NAFTA art. 101. (claiming compliance with GATT). *See also* Trade Policies for a Better Future: The Leutwiler Report, The GATT and the Uruguay Round (Arthur Dunkel ed. 1987); Richard W.T. Pohfret, Unequal Trade (1988); Andrew W. Shoyer, *Trade in Goods Under the North American Free Trade Agreement (NAFTA), in* Mexico—Investment and Trade: Progress and Prospects 1993, at 9 (PLI Com. L. & Practice Course Handbook Series, 1993).

GATT permits free trade areas despite the fact that they discriminate against parties to GATT who do not participate in them. The theory is that although the free trade area members discriminate against nonmembers, this promote the ultimate goal of GATT, the eventual elimination of trade barriers. *See* David E. Marko, *A Critical Review of Market Access in Central And Eastern Europe: The European Community's Role*, 17 Md. J. Int'l L. & Trade 1, 7 (1993).

Under GATT, members normally must grant all other members most favored nation ("MFN") status. *See* GATT art. XXVIII. GATT allows members of free trade agreements to withhold FTA benefits to non-free trade area GATT members only if certain conditions are met. *See* GATT art. XXIV. First, all duties and restrictive measures must be eliminated substantially between the parties. *See* GATT art. XXIV 8(b). Second, each contracting party in the free trade area must treat the other parties' goods no less favorably than its own. *See id.* NAFTA ostensibly meets these requirements. *See* Richard H. Steinberg, *Antidotes to Regionalism: Responses to Trade Diversion Effects of the North American Free Trade Agreement*, 29 Stan. J. Int'l L. 315, 337 (1993) (noting that GATT parties will assess the trade area's effects on trade as a whole rather than the effects on individual products in assessing GATT compliance).

Specifically, NAFTA's objectives are to: (a) eliminate barriers to trade in goods between the territories of the Parties; (b) to promote fair competition in the free trade area; (c) to increase the investment opportunities throughout the Parties; (d) to protect adequately intellectual property rights of each Party; (e) to create effective procedures for joint administration of the agreement and joint resolution of related disputes; and (f) to establish a framework to further "trilateral, regional and multilateral cooperation to expand and enhance the benefits" of the Agreement. *See* NAFTA art. 102. In the words of Mexican President Carlos Salinas de Dortari,

> [o]ur objective at all times during the [NAFTA] negotiations was to make the agreement consistent with GATT. This insures that no protectionist barriers against outside countries or regions will be erected around the huge North

qualify for duty-free[4] treatment the tomato puree must originate from

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American trade area. NAFTA is thus a building block of GATT, not a trade bloc formed at the expense of others. . . .

Nathan Gardels, *Salinas' Vision: After NAFTA, the World*, L.A. Times, Jan. 6, 1993, at B7.

In recent years, GATT parties have chosen to build free trade areas rather than to liberalize their trade laws universally or to construct customs unions. *See* Paul B. Stephan III, International Business and Economics: Law and Policy 80 (1993). Free trade area members import goods duty-free from each other. *See id.* However, they do not have common external tariffs, or a common customs frontier, as does the European Community. *See id.*

NAFTA, in fact, is only the most recent free trade area to which the United States belongs. In 1985, it joined its first general free trade agreement, the Israel-United States accord. *See* Israel-United States: Free Trade Area Agreement, Apr. 22, 1985, *reprinted in* 24 I.L.M. 654 [hereinafter U.S.-Israel FTA]. Later, in 1988, it joined the Canada-United States: Free-Trade Agreement, Jan. 2, 1987, 102 Stat. 1851, *reprinted in* 27 I.L.M. 281 [hereinafter CFTA].

3. NAFTA dedicates an entire chapter to determining whether a good originates within the member states for purposes of the agreement. *See* NAFTA ch. IV. In addition, hundreds of pages of appendices detail the rules. *See* NAFTA annex 301. The rules are as important as they are complicated, because only originating goods are eligible for preferential tariff treatment. *See* NAFTA ch. IV.

The problem of origin arises most often in the case of products containing parts from several countries—hybrid products. This issue may become more clear through a hypothetical.

Imagine a free trade agreement between Patria and Xandia. *See* Frederic P. Cantin & Andreas F. Lowenfeld, *Rules of Origin, The Canada-U.S. FTA, and the* Honda *Case*, 87 Am. J. Int'l L. 375, 376 (1993). If all of a product's components originate from within the joint territories of Patria and Xandia, then the product receives duty-free treatment in passing between the two countries. *See id.* However, where a product has components, some of which are imported from Tertia, the issue becomes what test the product must pass to acquire Patrian or Xandian citizenship. *See id.*

Because member states do not maintain a "common customs frontier", *see supra* note 2, rules of origin are especially important in free trade agreements. *See* Stephan, *supra* note 2, at 89. The rules of origin prevent duty-free exportation of goods from a country with a lower tariff to that with a higher tariff. *See id.* For example, if German automobiles were to carry a 15 percent tariff in Canada and a 25 percent tariff in the United States, importers would always ship German cars through Canada and transfer them duty free to the United States. *See id.* Therefore, in this hypothetical, rules of origin would have to be used to prevent the German cars from obtaining duty free entry from Canada to the United States.

4. Duties are taxes on imports. *See generally* Blacks Law Dictionary 505 (6th ed. 1990). The United States levies two types of duties under its foreign trade law. *See* Gesine Schmidt & Olaf Jansen, *Regular Organization of United States Foreign Trade, in* U.S. Trade Barriers: A Legal Analysis 107, 108 (Eberhard Grabitz & Armin von Bogdandy eds., 1991) [hereinafter U.S. Trade Barriers]. The United States Customs Service imposes regular duties according to predetermined schedules. For a discussion of these schedules, see *infra* Part I.B. In addition, there are special duties which result from administrative proceedings of the Department of Commerce and the International Trade Commission. *See* Schmidt & Jansen, *supra*, at 108-09. These duties are invoked through countervailing duty or antidumping statutes. *See id.* For a brief discussion of the role of rule of origin determinations in the application of statutes such as these, see *infra* Part I.A.

NAFTA provides that no party may increase or adopt any customs duty on originating goods of another party, except as otherwise provided. *See* NAFTA art. 302(1). Regular

within the territories[5] of the members to the agreement.[6] Much of the tomato purée used by American ketchup producers, however, comes from Chile.[7] Thus, American producers must either pay a duty on ketchup shipped to Canada and Mexico, or discontinue contracting with Chilean puree suppliers.[8]

Although NAFTA in fact contains hundreds of these goods-specific[9] rules of origin, few likely will engender as much controversy as those governing automobiles. Similar rules of origin for automotive products spurred tremendous administrative and political battles under the United States Canadian Free Trade Agreement. Moreover, although the member states undertook to rectify the problems with the CFTA's rules in NAFTA negotiations, the final formulations only will partially promote the goals of NAFTA.

Under NAFTA's rules of origin for automobiles and automobile parts,

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customs duties on originating goods must be gradually phased out according to the Schedule to Annex 302.2.

Nonetheless, the parties may impose tariffs under specified emergency conditions. *See, e.g.* NAFTA annex 300-B.4.1. (Textile and Apparel Goods Bilateral Emergency Actions (Tariff Actions)). Where a textile or apparel good originating in a member state is being imported into another member state's territory

> in such increased quantities, in absolute terms or relative to the domestic market for that good, and under such conditions as to cause serious damage, or actual threat thereof, to a domestic industry producing a like or directly competitive good, the importing Party may . . . increase the rate of duty on the good

within certain parameters. *Id.*

5. NAFTA thoroughly elaborates the meaning of "territories" of the parties. *See* NAFTA annex 201.1 (Country-Specific Definitions). The Canadian territory includes the territory to which its customs laws apply. *See* NAFTA annex 201.1(a). The Mexican territory includes the states of the Federation, the Federal District, and islands (including the island of Guadalupe). *See* NAFTA annex 201.1(b). Lastly, the territory of the United States includes the fifty states, the District of Columbia, and Puerto Rico. *See* NAFTA annex 201.1(c). The territory of each state also includes the rights of each to the seas and subsoil in accordance with international law. *See id.*

6. *See generally* NAFTA annex 401-159 (outlining requirements for origination of vegetable preparations).

7. *See* Bussey, *supra* note 2, at 9A.

8. *See id.* Ketchup is a new tariff item (number 2103.20.aa). *See* NAFTA annex 401-158 (new tariff items). Ketchup falls within Chapter 21 of the Harmonized System, Miscellaneous Edible Preparations. To qualify for duty free treatment under this chapter, ketchup must change to heading 2103.20 from any other chapter. However, tomato puree belongs to the same chapter. Therefore, it may not travel between the member states duty-free. If unprocessed Chilean tomatoes were imported, they would be classified under Chapter 8, Edible Fruit and Nuts, and ketchup made from them would travel duty-free.

Thus, because tomato puree belongs to the same chapter as ketchup, non-NAFTA puree may never be converted to ketchup and acquire duty-free treatment between the parties. Moreover, the costs of the other ingredients, the bottle, and processing are irrelevant. The only requirement for duty-free treatment of this product is a change in the tariff classification of all imported sub-elements.

9. According to NAFTA, goods include domestic products as understood in the GATT and include the originating goods of a party. *See* NAFTA art. 201. In plain english, the term goods refers to "commercial merchandise." *See* Schmidt & Jansen, *supra* note 4, at 107.

to qualify for duty-free treatment, a good must (1) undergo a change in tariff classification,[10] and (2) satisfy a value-added test requiring over 60 percent of its value to originate within the free trade area.[11] As under the CFTA, the value-added requirement will cause inconsistent and anomalous origin determinations.[12]

The value added component to the CFTA rules of origin generated bitter disputes between the United States and Canada[13] and made potential investors wary.[14] The CFTA signatories disputed the types of costs that should be included in calculating how much value was added in North America.[15] The United States Customs Service,[16] pursuant to its view of the type of value that may be included in value assessment, disqualified Canadian automobiles from duty-free treatment (subjecting the autos to import tariffs). The Customs Service determined that the Canadian cars contained too much non-originating value. The specter of added tariff costs caused foreign investors to become ambivalent about producing within the trade area.[17]

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10. "The process of classification may be described as the process of selecting the specific description of imports that most properly applies to the particular import presented for classification." Schmidt & Jansen, *supra* note 4, at 133.

11. A value-added test generally requires that for a product to originate in a country it must contain a certain percentage of value contributed in that country. *See id.* at 137.

12. This Note primarily address rules of origin for automobiles. Difficulties similar to those encountered with these provisions have occurred in other industrial sectors, however, and provide fertile examples of the problems inherent in rule of origin definitions. There have been, for instance, disputes in previous agreements concerning the origin of rolled steel and concerning the origin of textile products. *See infra* Part I.B. Throughout the Note, these examples help elucidate the difficulties of automotive provisions.

13. *See infra* Part II.A.

14. *See* Jeffrey J. Schott & Gary C. Hufbauer, Negotiating and Implementing a North American Free Trade Agreement 68-69 (Leonard Waverman ed., 1992) (noting that the rules of origin under the CFTA provided a "goldmine" for accountants and lawyers and led some firms to prefer paying the tariffs to completing the paperwork); *Treasury Official Notes Effort to Move Away from Value-Content Test in Chemical Sector*, 10 Int'l Trade Rep. (BNA) No. 10, 417 (Mar. 10, 1993) (citation omitted).

15. *See supra* Part II.A.

16. The Customs Service is a branch of the United States Treasury Department. *See* 19 U.S.C. § 2071 (1994). The entirety of the organization is currently being restructured pursuant to the Customs Reorganization Act—implemented with NAFTA.

The most pervasive change by the act is that it shifts the valuation and classification of merchandise to the importer. *See Customs Explores Reductions in Staff, Establishing Strategic Trade Centers*, 11 Int'l Trade Rep. (BNA) No. 9, at 343 (Mar. 2, 1994). According to the Customs Service, the importer's legal responsibility is to use "reasonable care" in providing the service with information. *See id.* This additional burden on the importer may further erode the attractiveness of using tariff preferences.

17. Japanese trade officials consider NAFTA's rules of origin to be "sneaky protectionism," *see* David Everett, *Fine Print on Free Trade: NAFTA Partners Put Their Interests First*, Det. Free Press, Nov. 3, 1993, at 1E, designed to create a "Fortress America." *See* Chwee Huay Ow-Taylor, *Facing the Challenge from NAFTA*, Bus. Times, Jul. 28, 1993, at 23.

The Japanese are not alone in their criticism of NAFTA. Many recently industrialized economies in Asia, including Hong Kong, Singapore, South Korea, and Taiwan, also fear that NAFTA's rules of origin will cause them considerable trade difficulty. *See* Morin Mushkat, *Eastern Asia: East Asia's Laid-Back Stance on NAFTA Points to Problem of*

Trade representatives endeavored to craft NAFTA's automobile rules of origin to avoid the CFTA's difficulties.[18] For instance, NAFTA clarifies the type of value considered to be within the originating value of automobiles and their components, adopting a more expansive definition.[19]

NAFTA, however, fails to remedy the greatest cause of the controversy under the CFTA, the Customs Service's interpretation of the automobile rules of origin value-added component.[20] Under the CFTA, the Customs Service disallowed certain American processing costs that, according to a dispute resolution panel, should have been included.[21]

Policy Inertia, Japan Econ. J./Nikkei Weekly, Dec. 13, 1993, *available in* WESTLAW, Int-News Database.

Specifically, the apparel, automobile, and auto parts industries of these countries risk not only trade diversion, but also investment diversion. *See id.*; Jonathan Marshall, *NAFTA Could Divert Trade From Asia*, S.F. Chron., Nov. 17, 1993, at C4. Mexico's attraction of investment rose sharply after the introduction of economic stabilization and trade liberalization programs in 1985. *See id.* Investment increased further as NAFTA negotiations proceeded and the agreement was ratified. *See id.*; Anna Taing, *Malaysia: East Asia Faces Big NAFTA Challenge-Lehmans*, Bus. Times (Malaysia), Dec. 15, 1993, at 1.

The term "fortress" has long been used to describe so-called protectionist trade practices. Some Europeans have called for a Fortress Europe to combat what they perceive as Japanese protectionism. *See* William Drozdiak, *Europe's New Rage: Japan-Bashing Fear of Tokyo 'Economic War Plan' Spreads as Unified Market Nears*, Wash. Post, June 16, 1991, at A19. *But see, United Yes; Fortress, No, Says Europe*, Chi. Trib., Oct. 20, 1988, at 1. In addition, European Community restrictions on Japanese cars sold in Western Europe, even on those made in Europe by Japanese owned companies, led to cries of Fortress Europe from outside the community. *See* Paul Blustein & Stuart Auerbach, *Trade Blocs: Friend or Foe? Some Asian Nations Fear New Regional Groupings May Foster Protectionism*, Wash. Post, June 2, 1991, at H1; Katherine Langley, *The Fortress Faces East: Protecting Europe's Auto Industry*, 1991 Wis. L. Rev. 1043, 1043 (1991) (arguing that despite "the EC's promises that Community-wide legislation will not yield 'Fortress Europe,' protectionism is still the overriding goal of European trade regulation.").

In addition, the single European financial market—a product of the Single European Act—has led United States business interests to cry "Fortress Europe." *See* Dr. Gerhard Wegen, *Transnational Financial Services—Current Challenges for an Integrated Europe*, 60 Fordham L. Rev. S91, S95 (1992). Former President Bush's reference to the "iron curtain of protection" descending on Europe also reflects the United States perception of the European Economic Community as a Fortress Europe. *See* Hobart Rowen, *U.S., German Officials Need to GATT Together*, Wash. Post, Mar. 15, 1992, at H1.

In addition, Japanese business and government leaders have publicly acknowledged outsiders' inability to penetrate their market, noting the accuracy of the term "Fortress Japan." *See* Paul Blustein, *Tokyo Woes: Shoring Up a Shaky Summit: Will the U.S.-Japan Trade Rift Wreck Global Cooperation?*, Wash. Post, July 4, 1993, at C1.

18. *See infra* Part III.A. Among its modifications, NAFTA has actually incorporated some provisions specific to certain brands of products. For example, Annex 403.2 relates specifically to the Regional Value-Content Calculation for CAMI Automotive, Inc. when producing motor vehicles in Canada for importation to the United States. Although these agreements are in themselves interesting, this discussion of rules of origin focuses on the rules generally applicable, rather than on company-specific provisions.

19. *See id.*

20. *See id.*

21. The CFTA created dispute resolution panels to resolve various types of controversies under the agreement. The panels included appointed representatives of both

Indeed, there was a collective proclivity to misconstrue value-added definitions. Canada also read the CFTA rules of origin to promote its own interests. By adopting a broad definition of value, Canada encouraged foreign producers to invest in Canadian production facilities to supply the United States market.[22]

Notwithstanding, under NAFTA, value-added determinations must become more predictable,[23] uniform,[24] and compatible with the General Agreement on Tariffs and Trade ("GATT")[25] than determinations under the CFTA. These are prerequisites to the benefits of free trade: increased investment[26] and improved economies of scale.[27] This Note evaluates the

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countries. *See* CFTA art. 1801. The signatory countries may request consultations "regarding any actual or proposed measure or any other matter that it considers affects the operation of [the] Agreement." CFTA art. 1805.

Only one panel decision under the CFTA concerns rules of origin. *See In the Matter of Article 304 and the Definition of Direct Cost of Processing or Direct Cost of Assembling*, USA-92-1807-01, Canada-U.S. Trade Comm'n Panel, Final Report (June 8, 1992) [hereinafter *In the Matter of Article 304*]. For a discussion of this decision, see *infra* Part II.A.

22. *See infra* Part II.A.2.

23. Predictability is crucial to promote foreign investment in the free trade area. In fact, the unpredictability of CFTA rules of origin, together with substantial accounting requirements, prevented manufacturers from taking advantage of reduced tariffs. *See infra* Part II.B.

24. Uniformity is required to prevent a member state with lower tariffs from serving as a platform for the duty free entry of goods into a member state with higher tariffs. One commentator has observed that uniformity has long been a problem. *See National and International Developments in the Rules of Origin and Duty Drawback, in* Proceedings of the Seventh Annual Judicial Conference of the United States Court of International Trade, 137 F.R.D. 509, at 581, 590 (1990) (comment of John Rode) [hereinafter Developments in Rules of Origin]. Uniformity has been a problem since the city states of Europe, particularly Venice, traded spices throughout the Middle and Near East under a regime of Most Favored Nation treatment. *See id.*

25. *See infra* Part I.C. (discussing GATT's prohibition of the protectionist use of rules of origin in non-preferential contexts).

The Uruguay Round agreement creates a World Trade Organization ("WTO") to replace the GATT-Bretton Woods trading system. Draft Agreement on Rules of Origin, Dec. 20, 1991, GATT Doc. MTN.TNC/W/FA, § D.1-14 [hereinafter "Uruguay GATT"]. The WTO will provide punitive measures for GATT violations and, thereby, occupy a more influential role in global trade. *See South Korea: Trade After Uruguay Round*, Korea Econ. Daily, Dec. 23, 1993, *available in* LEXIS, NEWS Library, CURNWS File.

26. *See* John M. Berry, *Economists Say Blocs May Block Free Trade, Regional Accords Seen as Troubling*, Wash Post, Sept. 4, 1991, at C1 (quoting Mexican Finance Minister Pedro Aspe in saying that a free trade agreement "will make possible a better use of economies of scale and will generate new investment and employment opportunities"); William Branigin, *Mexico Eyes Pacts with U.S., Canada; President Salinas Rules Out Any European-Style Common Market*, Wash. Post, May 24, 1990, at E1 (noting that Salinas has come to believe that a lesser-developed country can reap great benefits from a free trade agreement, including new investment, technology transfers and wage increases for Mexican workers).

27. To say that a free trade agreement will achieve economies of scale is to say that it will allow businesses to produce where it is most cost efficient. Ultimately, these economies benefit consumers who enjoy lower prices. *See* Alexander Trotman, *We Are Much More Competitive Now, But I Am Not In the Least Bit Complacent About the Japanese*, Det. Free Press, Feb. 9, 1994, at 11A.

value-added components of NAFTA's rules of origin for automobiles and surveys the mechanisms available in NAFTA and GATT to revise them.

Part I of this Note surveys rules of origin. Such rules arise not only in free trade agreements, but also in quotas, countervailing and antidumping duties, and national technical requirements.[28] They are becoming an increasingly important aspect of international trade. Part I also traces the modern trend to adopt more objective standards in developing rules of origin. Part II addresses the CFTA rules of origin for automobiles and disputes between the United States and Canada on the interpretation of these rules. Part III evaluates NAFTA's rules of origin. This Part also details rules of origin coordination provisions—under both NAFTA and GATT. This Note concludes that the United States should cooperate with the other NAFTA member states—through both NAFTA and GATT provisions—to develop NAFTA's rules of origin in harmony with GATT principles.

I. SPECIES OF ORIGIN

Rules of origin, which vary greatly in form, occupy an important role in divergent trade contexts. The importance of these rules has led to a global trend to implement more objective criteria to achieve consistent results. This Part surveys the trade contexts in which rules of origin apply, and traces the historical approach to origin determinations. This study reveals the importance of consistency in origin determinations.

A. *Trade Contexts Employing Rules of Origin*

Rules of origin are crucial to the development of a free trade area. A free trade area grants its duty-free benefits exclusively to member state goods.[29] Rules of origin determine whether a given good originates within the member states and, therefore, qualifies for duty-free treatment. Free trade areas, however, are not the only context in which trade benefits are dependent on a product's national origin.

Over the last twenty years, rules of origin have become exceedingly important as nations have increasingly relied on tariff preferences, "buy national" requirements, voluntary restraint agreements, and antidumping and countervailing duty orders to open markets for some products and producers and to close markets for others.[30] All these policies require the use of rules of origin.

Outside free trade areas, many industrialized countries treat goods of

28. For a discussion of the full range of trade areas using rules of origin, see *infra* Part I.A.

29. *See supra* note 2.

30. *See* Judith H. Bello & Alan F. Holmer, *The Growing Importance of Rules of Origin*, *in* Trade Law And Policy Institute 1989, at 211, 213-15 (PLI Com. L. & Practice Course Handbook Series No. 510, 1989).

developing countries preferentially.[31] For example, since 1975, the United States has applied a General System of Preferences to allow products from specified developing countries to enter the United States duty-free.[32] To ensure that only the specified countries take advantage of the preferential treatment, the GSP includes strict rules of origin that allow the Customs Service to determine product eligibility.[33] The European Community maintains similar programs to accord preferences to the North African countries that are former European colonies, such as Morocco.[34] Thus, both free trade agreements and developing country programs use rules of origin to grant preferential treatment to certain goods.

Other agreements, however, use rules of origin to prevent the importation of, or to discriminate against, other countries' goods. Voluntary restraint agreements are one method.[35] For example, the United States has entered into voluntary restraint agreements to limit foreign steel producers' shipment of steel into the United States market.[36] To avoid the importing country's imposition of legislated import restraints or quotas, the producing country agrees to restrict its exports. Japan, for example, voluntarily restrains its automotive and electronics exports to Europe and the United States.[37] Although voluntary restraint agreements contravene free trade[38] and may violate GATT[39] because they distort the

31. *See* GATT Contracting Parties, Decision of Nov. 28, 1979, Differential and More Favorable Treatment Reciprocity and Fuller Participation of Developing Countries, GATT, Basic Instruments and Selected Documents, 203 (26th Supp. 1980) [hereinafter BISD]. *See also* Thomas M. Franck, *Legitimacy in the International System*, 82 Am. J. Int'l L. 705, 750 (1988) ("While GSP is inconsistent with MFN, it coheres with the underlying purpose of GATT, which is to increase trade for all nations.") The GATT grants waivers to MFN requirements in the case of programs to assist developing countries.

32. The United States GSP was enacted in 1974. *See* Trade Act of 1974, 19 U.S.C. § 2461 (1994). The statute authorizes the president "to provide duty-free treatment for any eligible article from any beneficiary developing country." *Id.*

33. *See* Bello & Holmer, *supra* note 30, at 217.

34. *See id.* Morocco was formerly a colony of France.

35. The United States has a long tradition of voluntary restraint agreements. Some commentators suggest that these agreements date back to the 1930's—to agreements with Japan to limit the importation of cloth, floor coverings, hosiery, velveteen, and corduroy products. *See* Jeanette Schüler, *Voluntary Export Restraints*, *in* U.S. Trade Barriers, *supra* note 4, at 463, 474. There have also been more recent agreements. For example, on May 1, 1981, the United States and Japan signed a Voluntary Restraint Agreement on automobiles to last three years. *See Twenty-Seventh Annual Report of the President on the Trade Agreements Program*, 3 Int'l Trade Rep. (BNA) 234, Feb. 19, 1986. This restricted imports of passenger cars by 8%. *See id.* Various transition agreements have since transpired. *See* Schüler, *supra*, at 474.

36. *See generally* Jose A. Mendez, *The Short-Run Trade & Employment Effects of Steel Import Restraints*, 20 J. World Trade L. 554, n.154 and accompanying text (noting that those agreements would reduce steel imports and preserve employment in the American steel industry).

37. Because Japanese products often undergo processing in third countries, importing countries often dispute whether a given good is Japanese and falls within the restraint agreement.

38. *See e.g.* Peter Wong, *The Japanese Automotive Voluntary Restraint Agreements and International Law*, 23 Canadian Y.B. Int'l L. 297, 302 (1985) (equating the agree-

flow of goods in the international market,[40] they continue to exist and to depend on rules of origin.

Another restriction based on rules of origin is a "buy national" requirement.[41] This type of regulation restricts the range of products eligible for government procurement to domestically-produced articles.[42] For example, to bid on a contract to provide defense equipment to the United States,[43] the bidder's product must originate within the United States. The rule aims to protect domestic industries.[44]

Although GATT generally prohibits buy national requirements, it provides an exception for government procurement.[45] As governments have played a larger role in economic development, however, markedly more trade has come within the governmental procurement exemption.[46] Because buy national requirements retain their vitality in the government procurement area, rules of origin will continue to be important in this context.

Origin determinations concerning national technical requirements may also divert imports, although the role of origin determinations here is slightly more tenuous. For example, under United States emission standards, automobile producers must maintain an average fuel efficiency rating for their *domestically* produced fleets.[47] The rule forces United States

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ments to an indirect form of legislated import quotas); Michael W. Lochmann, *The Japanese Voluntary Restraint on Automobile Exports: An Abandonment of the Free Trade Principles of the GATT and the Free Market Principles of United States Antitrust Laws*, 27 Harv. Int'l L.J. 99, 111 (1986) (stating that the gain realized with voluntary export restraints in effect is less than would be derived through free trade).

39. *See* GATT art. XI (prohibiting quantitative restrictions on the importation of goods). Voluntary restraint agreements are informal bilateral agreements and violate the principle of non-discrimination. *See* GATT art. XIII. ("No . . . restriction shall be applied by any contracting party . . . on the exportation of any product destined for the territory of any other contracting party, unless the exportation of the like product, to all third countries, is similarly . . . restrained.")

40. Such agreements entrench trade disparities between parties. *See* Starla Henrichs-Cohen, *EEC Treaty Article 115 — the Surviving Safeguard: Ridding Residual Member State Protection in the Single Market*, 24 Law & Pol'y Int'l Bus. 553, 553-55 (1993). Moreover, such measures lack transparency and, therefore, prevent regulation. *See id.*

41. The first federal statute to introduce "buy American" preferences was in 1845. *See* Appropriations Law for Fiscal Year 1845, 28th Congress, Sess I., 5 Stat. 681, ch. 105 (1844) (codified at 2 U.S.C. § 109 (1988)). It precluded the purchase of foreign products where suitable domestic products could be obtained at reasonable prices. *See id.*

42. *See generally* Schmidt & Jansen, *supra* note 4, at 108-09.

43. *See e.g.* 10 U.S.C. § 2507(d) (1988) (providing that specified tools must be purchased domestically by the Department of Defense for fiscal years 1989-1991).

44. *See* Schmidt & Jansen, *supra* note 4, at 110.

45. *See* GATT, Agreement on Government Procurement, *in* BISD, *supra* note 31, at 33.

46. *See* Geraldo Pascual, Note, *State Buy American Laws in a World of Liberal Trade*, 7 Conn. J. Int'l L. 311, 312 (1992).

47. The manufacturers normally would be able to include only those cars that they produce in the United States in their average. *See* Corporate Average Fuel Economy Regulations ("CAFE"), 40 C.F.R. § 600.513 (1981). CAFE imposes a "gas guzzler" tax on automobile fleets with low average fuel efficiency. *See id.* However, Mexico has won a

manufacturers to produce enough fuel efficient cars domestically to meet the requisite average domestic car efficiency threshold after accounting for domestic luxury car production.[48] The domestic fuel efficiency standard thereby forces United States manufacturers to produce their most fuel efficient cars in the United States.

Antidumping and countervailing duty laws also rely on origin determinations. Antidumping duties penalize foreign producers for unfairly pricing.[49] Countervailing duties address governmental behavior, including subsidizing[50] firms to sell at unfair prices in foreign markets.[51] These measures only apply to designated countries and a product's treatment depends on its country of origin. For example, European Community rules of origin prevent the Japanese from merely assembling goods, in so-called "screwdriver" (or assembly) plants, to avoid antidumping or countervailing duty laws imposed against Japanese products.[52]

Common to all of these uses of rules of origin is the need to determine where a given good originates. Some methods of assessment, however, may reveal more consistent results than others. For this reason, an analysis of the types of tests used is crucial. Although this note addresses the need for reform only in the context of NAFTA's automobile rules of origin, the analysis may apply equally to other contexts of origin determinations discussed above.

B. *Methods of Determining the Country of Origin*

Traditionally, countries have relied on rules of "substantial transformation," an assessment of whether a product has undergone ample metamorphosis in a given location, to decide a product's country of origin. Such formulations, however, are vague, difficult to implement and, more importantly, unpredictable for investors. These characteristics make the substantial transformation test undesirable in the free trade context.

Consequently, recent free trade agreements, including the CFTA and NAFTA, have adopted alternative systems based on a change in Harmonized System tariff classification.[53] A Harmonized System framework

concession under NAFTA that American cars produced in Mexico may be included in determining American fuel efficiency calculations. *See* NAFTA annex 300-A.

48. For a discussion of the American automobile companies' tendency to reduce their average fuel consumption by including fuel-efficient cars in their averages, see Julie Wolf, *US Is Taxed With Discriminating Against European Cars*, The Guardian, May 12, 1993, at 11.

49. *See* Stephan, *supra* note 2, at 88.

50. For a discussion of subsidies, see Gillian Dell, *Indirect Restrictions on Foreign Trade in* U.S. Trade Barriers, *supra* note 4, at 503, 555-57.

51. *See id.*

52. The European Community has struggled to ensure that only member states benefit from their Customs Union. *See* Patrick J. McDermott, Note, *Extending the Reach of Their Antidumping Laws: The European Community's 'Screwdriver Assembly' Regulation*, 20 Law & Pol'y Int'l Bus. 315, 316 (1988).

53. International Convention of the Harmonized Description and Coding System, June 14, 1983 [hereinafter Harmonized System]. *See* 19 U.S.C. §§ 3001-3012 (1988).

improves upon the substantial transformation test in that it is more objective and more widely used across the globe.

The current agreements using the Harmonized System, however, have compromised the system's benefits by combining the system with value-added requirements. These value-added requirements introduce a substantial element of indeterminacy in an otherwise greatly improved system. This indeterminacy has spurred the battles under the CFTA, and remains in the wings to reek havoc under NAFTA.

1. The Rule of Substantial Transformation

Trade agreement rules of origin traditionally have used vague and unpredictable[54] rules of substantial transformation.[55] Under this type of test, no one factor is determinative.[56] Rather, the substantial transformation query assesses whether there is a change in the "commercial

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The United States Omnibus Trade and Competition Act of 1988 implements the International Convention on the Harmonized Commodity Description and Coding System and the Harmonized Tariff Schedules of the United States. These new tariff schedules replace the old Tariff Schedules and conform to the schedules of the world's major trading countries. *See* Mark R. Joelson, et al., *U.S. Omnibus Trade and Competitiveness Act of 1988*, 16 Int'l Bus. Law. 408, 413 (1988).

54. *See* Edward H. Davis, Jr., Comment, *National Juice Products Association v. United States: A Substantial Transformation of the Country-of-Origin Substantial Transformation Test?*, 19 U. Miami Inter-Am. L. Rev. 493, 497 (1987-88) (stating that application of the rule is difficult when the country of export is an intermediary); David Palmeter, *Rules of Origin or Rules of Restriction? A Commentary on a New Form of Protectionism*, 11 Fordham Int'l L.J. 1, 10 (1987) (describing judicial confusion in interpreting the rule of substantial transformation). *See also* Paul Asker, Note, *Changes in the Rules of Origin in the United States-Canada Free Trade Agreement: A Preliminary Evaluation*, 36 Wayne L. Rev. 1545, 1549 (1990).

55. *See* 19 C.F.R. § 134.1(b); Ruth F. Sturm, 1 Customs Law & Admin. § 15.1 (1993). Among the United States agreements which rely on this test is the Caribbean Basin Initiative. *See* William H. Cavitt, *Western Hemisphere Free Trade Initiatives*, 18 Wm. Mitchell L. Rev. 271, 286 (1992).

Other countries also recognize the rule of substantial transformation. For example, the European Community recognizes the rule. *See* Peter Montagnon, *EC Unable to Bar Hondas Made in US, Says UK Minister*, Fin. Times (London), Jan. 9, 1991, at 4. Under this test, Japanese cars undergoing substantial transformation in the United States would not be counted against Japanese quotas. *See Cars: Renewed Controversy on Japanese Transplants*, Eur. Rep. (Eur. Info. Serv., Brussels), Jan. 12, 1991, at 7; *Cars: Freeze on Japanese Imports into EEC until January 1, 2000*, Transp. Eur., (Eur. Info. Serv., Brussels), Sept. 25, 1991. The EC has many rules for specific products. *See, e.g.*, Council Regulation 37/70, 1970 O.J. (L 7) 6 (pertaining to spare parts); Council Regulation 2632/70, 2970 O.J. (L 279) 35 (pertaining to radios and televisions); and Council Regulation 964/71, 1971 O.J. (L 104) 12 (pertaining to textiles). *See generally*, Est M. Sinan, *European Community Customs Duties: A Significant Trading Consideration for the U.S. Companies*, 18 Wm. Mitchell L. Rev. 401 (1992) (discussing the European Community's customs duty system). The Caribbean Community ("CARICOM") also uses a substantial transformation text. *See* Treaty Establishing the Caribbean Community, July 4, 1973, 12 I.L.M. 1033 (1973) (entered into force Aug. 1, 1972).

56. *See* Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556, 560-62 (1908) (holding that substantial transformation occurs where a product emerges with "a distinctive name, character, or use" (citation omitted)); *see also* Torrington Co. v. United States, 764 F.2d 1563, 1568 (Fed. Cir. 1985) (stating that "substantial transformation occurs

designation or identity," the "fundamental character," or the "commercial use" of a product.[57] The test may also look to a change in the "form, appearance, nature, or character of an article which adds to the value of the article an amount or percentage which is significant in comparison to the value which the article had when exported from the country in which it was first manufactured, produced, or grown."[58]

A United States Customs Service ruling, for example, addressed whether a Canadian steel slab had been substantially transformed through being hot rolled into steel plate and heat treated in Belgium.[59] On the one hand, if the steel slabs that traveled from Belgium to the United States were Belgian, they would be subject to a Belgian voluntary restraint agreement.[60] On the other hand, if they were Canadian, they would qualify for preferential treatment under the CFTA.[61] According to the Customs Service the Belgian heat process resulted in "substantial metallurgical changes," and, therefore, a substantial transformation.[62] The Customs Service believed that the fact that more than 50 percent of the final resale price of the steel plates was attributable to the initial value of the Canadian slab was not determinative.[63] It noted, further, that substantial transformation could occur even when processing constitutes only 15 percent of the value added.[64] Thus, the range of factors and the complexity of modern production processes render the substantial transformation test unworkable.[65]

2. The Harmonized System

In response to the substantial transformation difficulties, many countries have chosen to determine product origin according to changes in Harmonized System tariff classification.[66] The Harmonized System eliminates much of the subjectivity from country of origin determinations by

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when an article emerges from a manufacturing process with a name, character or use which differs from the original material subject to the process" (citation omitted)).

57. *See* 19 C.F.R. 12.130(d)(1) (1992); *see also* 1993 WL 274541, *2 (Customs).

58. United States v. Murray, 621 F.2d 1163, 1169 (1st Cir. 1980); *see also Torrington Co.*, 764 F.2d at 1567-68.

59. *See* 1992 WL 252940 (Customs) (Mar. 30, 1992); *see also, e.g.*, 1992 WL 440471, *2 (Customs) (Mar. 24, 1992).

60. *See* 1992 WL 252940, at *2.

61. *See id.* at *3.

62. *Id.*

63. *See id.*

64. *See id.* at *2 (citing HQ 081659).

65. *See generally* Book Review, 21 J. World Trade L. 98 (1987) (discussing Standardization of Rules of Origin, U.S. International Trade Commission).

66. *See* C. Edward Galfand, *Heeding the Call For A Predictable Rule of Origin*, 11 U. Pa. J. Int'l Bus. L. 469, 489-90 (1989).

Not only is the Harmonized System better than the rule of substantial transformation, but it is better than the prior system of tariff classifications of the United States—the Tariff Schedules of the United States. The Harmonized Schedule "limits the discretionary interpretation power of United States authorities." *See* Schmidt & Jansen, *supra* note 4, at 133.

ruling that a good is the product of the nation where it last underwent a change in classification.[67] The Harmonized System of classification is highly specific and products are relatively easily classified. Although trade lawyers still dispute the category under which a given good falls, the test is infinitely more predictable than the rule of substantial transformation.[68]

For example, the Customs Service easily determined that "cotton-wrapped, rubber-core" yarn should enter into the United States from Canada duty-free.[69] The yarn had earlier been produced in the United States. The rubber had been produced in Malaysia. The Customs Service had to determine whether weaving these components in Canada resulted in a Canadian product for purposes of the CFTA.[70] The Customs Service noted that, for purposes of the agreement, only foreign-originating materials needed to undergo a change in tariff classification to claim duty-free treatment.[71] Thus, because the Malaysian rubber cord changed tariff classifications in transforming from its "unaltered state"[72] to being "gimped" with cotton, the product qualified for duty-free treatment.[73]

The other important benefit of using the Harmonized System is the global familiarity with the system. GATT members uniformly use the Harmonized System in many origin contexts.[74] They have a working understanding of the system.[75] Using this system allows each country to predict customs determinations abroad. Thus, the familiarity with the Harmonized System facilitates investment.[76]

3. Value-Added Requirements

Many rules of origin, including those of both the CFTA and NAFTA automobile rules of origin, however, attach value-added requirements to the general system of tariff classification requirements. Although the Uruguay Round of GATT will disallow value-added rules in non-preferential trade contexts, it will not affect value-added rules in preferential contexts.[77] In contrast to the Harmonized System, value-added requirements cloud country of origin determinations.

Judges and commentators have widely criticized value-added requirements.[78] Under the value-added definitions, it is nearly impossible to de-

67. *See* Galfand, *supra* note 66, at 490.
68. *See id.*
69. *See* HQ 952802, 1993 WL 274541 (Customs)(RE: country of origin and Canada Free Trade Agreement eligibility of cotton-wrapped, rubber core yarns made in Canada).
70. *See id.* at *4.
71. *See id.*
72. *Id.*
73. *See id.*
74. *See id.*
75. *See id.*
76. *See id.*
77. *See infra* Part I.C.
78. *See, e.g.* Developments in Rules of Origin, *supra* note 24, at 292 (comment of John Simpson, Deputy Assistant Secretary of the Treasury for Regulatory, Tariff and

termine whether costs are properly allocable to a given product.[79] The value-added requirements must be better defined to avoid these troubles. GATT may provide valuable means to achieve this end.

C. *GATT World Trade Organization as a Forum to Reconcile NAFTA Rules of Origin with GATT Principles*

GATT's forthcoming World Trade Organization[80] would prohibit the use of non-preferential rules of origin—those outside of free trade agreements—to create non-tariff barriers[81] to trade.[82] According to the WTO, non-preferential rules of origin must be administered in a "consistent, uniform, impartial and reasonable manner."[83] In addition, they may not be "used to influence trade or to create distortions or restrictions of trade."[84] The WTO would disallow value-added tests in non-preferential contexts because they cause such distortions.[85]

Although the guidelines do not yet apply within free trade agree-

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Trade Enforcement) ("Virtually all the problems, and absolutely all the serious problems, come with the value-added change.").

79. *See infra* Part II.A (discussing the difficulties of value added determinations within the CFTA).

80. Under the Uruguay round of GATT, the WTO replaces the Bretton Woods trading system. *See* Uruguay GATT, *supra* note 25, D.1-14 art. 4(1) (discussing the difficulties of value added determination within the CFTA).

81. Non-tariff barriers to trade include restrictive customs inspection and valuation rules, quotas, licensing requirement, and technical barriers. The United States consistently has pursued multilateral negotiations to eliminate tariff and non-tariff barriers since the Kennedy Round in the mid-1960's. *See generally* A. Paul Victor, *Trade Relief Laws and Other Trade-Related Measures Most Likely to Impact on Transborder Transactions, in* International Commercial Agreements 1993, at 693 (PLI Com. L. & Practice Course Handbook Series, 1993); *see also* Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 Harv. Int'l L.J. 47 (1993) (discussing GATT's focus on eliminating both Tariff and non-tariff barriers).

One of the benefits of a free trade area over general GATT treatment is that GATT has failed adequately to address non-tariff barriers. *See* Joseph L. Brand, *The New World Order of Regional Trading Blocks*, 8 Am. U. J. Int'l L & Pol'y 155 (1992). The free trade area allows parties to combat non-tariff barriers in a more narrow context. *See id.*

According to a recent study, non-tariff barriers are the most frequent subject of GATT complaints. *See* Robert E. Hudec et al., *A Statistical Profile of GATT Dispute Settlement Cases: 1948-1989*, 2 Minn. J. of Global Trade 1 (1993). For the entire 42 years of GATT existence, non-tariff barriers have been the subject of 52 percent of all complaints. *See id.* These were followed by tariffs, subsidies, and antidumping and countervailing duty measures. *See id.* Moreover, tariffs have declined over time and non-tariff barriers have become much more important. *See id.*; *see generally* Steinberg, *supra* note 2, at 323 ("Perhaps the most pervasive means of exacerbating trade diversion in recent years has been the calculated manipulation of a region's rules of origin.").

82. *See* President Clinton's Submission to Congress of Documents Concerning Uruguay Round Agreement, Dec. 15, 1993, Daily Rep. for Executives (BNA), Dec. 17, 1993, at M241. The agreement only applies to rules of origin "other than rules of origin relating to the granting of tariff preferences." *Id.*

83. *Id.*; *see also International Trade: Uruguay Round Ends in Geneva; Major Provisions of Deal Outlined*, Daily Rep. for Executives (BNA), Dec. 16, 1993, at C240.

84. *Id.*

85. *See id.*

ments,[86] the GATT parties may agree to implement them.[87] GATT provides means for the parties to do so.[88] For example, it provides for a Rule of Origin Committee to recommend policies for the GATT parties to adopt.[89]

United States trade representatives should use GATT to reform the guidelines for preferential rules of origin. United States officials endorsed these guidelines to combat the European Community's rules of origin.[90] The United States could now both reform its own rules of origin and obtain greater access to the European Community.[91] GATT allows such a change through providing that its members may by joint action accept an "understanding" that prohibits the misuse of rules of origin in preferential contexts.[92]

In sum, to prevent discordant applications of rules of origin and to ensure a stable investment climate, NAFTA member states must carefully define their value measuring terms. The value-added component that the member states have chosen requires consistent application. Guidelines will facilitate origin determinations, and will ease international trade and political relations.

II. *United States Customs Service Interpretations of the CFTA's Rules of Origin*

Under the CFTA, the United States Customs Service construed the rules of origin to prevent the duty-free entry of several automobile models from Canada.[93] Canadian officials were outraged,[94] and brought their

86. *See id.*

87. *See* Uruguay GATT, *supra* note 25, XXIV:4.

Cabining the restrictive provisions to non-preferential rules of origin does not mean that rules of origin may be used for any purpose whatsoever. Uruguay GATT art. XXIV:4 stipulates that the parties should not create free-trade areas "to raise barriers to trade of other contracting parties with the [free-trade area member] territories." Uruguay GATT art. XXIV:4. However, the use of the word "should," as opposed to "must" or "shall" suggests that this provision would provide no basis to question a free-trade area. *Cf.* Steinberg, *supra* note 2, at 339 (discussing GATT's guidelines with regard to non-tariff barriers in the free trade area context). Moreover, to establish that a free-trade agreement was designed to raise barriers presents more of a burden then to establish that it has these effects. Free-trade area members could proffer a host of other reasons justifying their reasons for building of the free-trade area.

88. *See generally* Steinberg, *supra* note 2, at 340 (discussing all of the potential GATT mechanisms to achieve a ban on misuse of rules of origin in preferential trade contexts).

89. *See id.*

90. *See infra* Part III.B.1.

91. *See id.*

92. *See* Uruguay GATT, *supra* note 25, art. XXVI:1. This states in relevant part, "Representatives of the contracting parties shall meet from time to time for the purpose of giving effect to those provisions of [the] Agreement which involve joint action and, generally, with a view to facilitating the operation and furthering the objectives of the Agreement." Uruguay GATT, *supra* note 25, art. XXV:1. This type of action is usually taken in the monthly GATT Council meetings or annual Contracting Parties' Sessions. *See* Steinberg, *supra* note 2, at 352.

93. For a discussion of the issues of *G.M.-Suzuki*, see *In the Matter of Article 304,*

concerns to a binational dispute resolution panel.[95] The panel found, in *G.M. Suzuki*[96], that the Customs Service had misapplied the value-added rules.

This Part explains the problems with the Customs Service's interpretations of the CFTA's rules of origin. It also addresses the ramifications of these Customs Service interpretations of the rules of origin. The consequences of the misinterpretation of the rules of origin under CFTA will be replicated under NAFTA if the rules of origin are not improved.

A. *CFTA Rules of Origin*

Under the CFTA, a good traveled duty-free between the United States and Canada if it met one of several tests.[97] The test that applied to automobiles not wholly obtained or produced within the free trade area, i.e., goods containing third-country components (so-called "hybrid goods") contained both a change in tariff classification component and a value added component.[98]

Hybrid automobiles or parts only travelled duty-free between the member states if processing or assembly within the states had resulted in the requisite change of tariff classification.[99] The member states assessed CFTA changes in tariff classifications according to rules corresponding

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supra note 21, at 1. Rulings pertaining to *Honda* include: U.S. Customs Memorandum 089427, at 3 (Dec. 9, 1991); Memorandum HQ 000160 (Feb. 27, 1992) (internal Customs Service Memorandum); Memorandum HQ 000164 (Apr.30, 1992) (internal Customs Service Memorandum).

94. *See infra* Part II.B.

95. *See id.*

96. *See In the Matter of Article 304, supra* note 21, at 1.

97. The Rules of Origin of the CFTA read in pertinent part:

> For the purposes of implementing the tariff treatment contemplated under the Agreement, goods originate in the territory of a Party if—
>
> (A) they are wholly obtained or produced in the territory of either Party or both Parties; or
>
> (B) they . . . have been transformed in the territory of either Party or both Parties so as to be subject to a change in tariff classification as described in the Annex rules or to such other requirements as the Annex rules may provide when no change in tariff classifications occurs . . . .

CFTA art. 301.

There are a total of three tests. The first applies to agriculture products or products such as minerals that originate from within the free trade area. The second applies when there has been a change in classification. Within this category, goods may also be required to pass a value added test. The third test applies where there has not been a change in classification because of technical reasons, but enough value has been added that the agreement still accords the good preferential treatment. *See generally*, Shelly P. Battram & Blake Murray, *The United States—Canada Free Trade Agreement and North American Automotive Production, in* The U.S./Canada Trade Agreement, at 37 (PLI Comm. L. & Practice Course Handbook Series No. 494, 1989) (discussing generally the CFTA rules of origin that apply to automobiles).

98. *See* Cantin & Lowenfeld, *supra* note 3, at 377-78.

99. *See generally supra* Part I.B.2 (discussing the Harmonized System rule of origin test).

to the Harmonized System.[100]

With regard to Harmonized System classification under the CFTA, transforming a good from one *chapter* to another was sufficient to allow duty-free treatment under the CFTA, but changing it from one *heading* within a chapter to another heading within the same chapter was insufficient.[101] For example, similar to the NAFTA ketchup scenario,[102] foreign cotton yarn could not acquire duty-free treatment through being woven into rope.[103] Both cotton yarn and rope were of the same chapter.[104] Automobiles and parts also had to change chapters to satisfy a change in Harmonized System classification.[105]

In addition to the change of classification, however, automobiles and parts also had to meet a value-added test.[106] Under the CFTA, both cars and car components were required to contain 50 percent of originating[107] value.[108] Thus, even if a hybrid car changed tariff classifications in the free trade area, it was required to meet the value-added threshold to qualify for CFTA preferential treatment.

Interestingly, if a component originated from within the free trade area, the CFTA deemed the *entirety* of the component's value to originate within the free trade area in determining the origin of a car into which the component was incorporated. This was so even where the component contained a significant amount of foreign material. This was the so-called roll-up rule. Similarly, a component was considered to have zero originating value, "even if it contain[ed] substantial American or Canadian ingredients—[the] so-called roll-down [rule]."[109]

The value-added component of the CFTA rules of origin for automobiles led to two prominent controversies—the *G.M.-Suzuki*[110] and *Honda*[111] disputes.

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100. *See id.*

101. *See* Cantin & Lowenfeld, *supra* note 3, at 379.

102. *See supra* notes 1-3 and accompanying text.

103. *See* HQ 952802, RE: Classification, country of origin and Canada Free Trade Agreement eligibility of cotton-wrapped, rubber core yarns made in Canada; subheading 5604.10.0000, HTSUSA, 1993 WL 274541 (Customs).

104. *See id.*

105. *See* CFTA art. 304 and annex 301, para. 2.

106. *See id.*

There are three methods which most nations use in determining a good's origin: (1) the rule of substantial transformation; (2) the change of tariff heading rule, and (3) the value added test. *See* Ralph H. Sheppard, Esq., *NAFTA Rules of Origin from the Importer's Perspective: What the Agreement Should Contain*, 1 Mexico Trade L. Rep. 20 (1991).

Traditionally, the United States has relied on the rule of substantial transformation. Under this rule, a product originates within the exporting country if "a new and different article of commerce emerges, having a distinctive name, character and use." *Id. See generally* Part I.B.1 (discussing the problems of the rule of substantial transformation).

107. *See supra* note 3 and accompanying text.

108. *See* CFTA art. 301.

109. *Id.*

110. *See infra* note 112 and accompanying text.

111. *See infra* note 122 and accompanying text.

1. CFTA Chapter XVIII Dispute Resolution Panel Decision in *G.M.-Suzuki*

G.M.-Suzuki[112] was a controversy involving General Motors and the Suzuki Motor Corporation, joint venturers in an Ontario Cami plant. The member states had to decide whether to include as North American a cost that was neither expressly included nor expressly excluded in the definition of "direct cost of processing or direct cost of assembling."[113] The parties debated whether non-mortgage interest should be included within CFTA originating value.[114] Canadian authorities allowed the value, because the value was attributable to the production of the goods.[115] The United States Customs Service, to the contrary, disallowed non-mortgage interest.[116] According to Customs Service officials, the value was not attributable to the production of the goods.[117] A CFTA Chapter Eighteen dispute resolution panel resolved the dispute, finding that non-mortgage interest should be included in originating value.[118] The most important aspect of the decision was the panel's approach to the controversy, however.

The panel looked for the purpose of the distinction between the included and the excluded costs and found that the purpose was to distinguish direct costs of manufacture from general expenses.[119] The member states wanted to reward those who produced in the free trade area, but only those producers. Toward that purpose, the panel recommended that interest costs of machinery were direct costs and should be included in the North American content.[120] The panel found that interest on machinery is as central to the value of a good as mortgage interest.[121]

2. Honda[122] Brouhaha:[123] The Transplant Controversy

Honda initially entered the American market by manufacturing a subcompact three-door Civic in Ontario, Canada. Although the Civics were completed in Canada, their engines were made in Ohio using United States aluminum ingot and cast iron cylinder sleeves, and several Japa-

112. *In the Matter of Article 304, supra* note 21, at 1.
113. *See* Cantin & Lowenfeld, *supra* note 3, at 381.
114. *See* In the Matter of Article 304, *supra* note 21, at 1.
115. *See* Cantin & Lowenfeld, *supra* note 3, at 184.
116. *See id.*
117. *See id.*
118. *See In the Matter of Article 304, supra* note 21, at 1.
119. *Id.*
120. *See id.* The parties accepted this recommendation and closed the *GM-Suzuki* case. *See id.*
121. *Id.*
122. "Of all Japanese auto companies, Honda has operated in the U.S. for the longest and claims the highest U.S. content. It is a pioneer, and thus has emerged as a potent symbol of this debate." Paul Magnusson, *Honda: Is it an American Car?*, Bus. Week, Nov. 18, 1991, at 105.
123. *See ITC: Rules of Origin Study*, 1 Mexico Trade & L. Rep., No. 2, Nov. 1, 1991 (coining the term "Honda brouhaha").

nese parts.[124]

Honda of Canada qualified the United States manufactured Civic engines for duty-free shipment from the United States to Canada.[125] The Customs and Excise branch of Revenue Canada held that the United States engine contained sufficient North American value to qualify as originating.[126] It found that the North American value content of the Ohio engines was approximately 66 percent.[127] Because the percentage of value required for duty-free treatment was 50 percent,[128] the agency qualified the engines for duty-free treatment.[129]

Honda of Canada incorporated these engines into Civics, along with other North American and non-North American components. Honda then claimed that the shipment of the Canadian Civics to the United States satisfied the 50 percent value threshold for duty-free shipment by virtue of the North American value of the engines and other parts. They reasoned that because the engines originated in North America, their entire value would be North American in calculating the value distribution of the Canadian automobile. Although a hybrid good contains significant value from third countries, if it originates within the free trade area it travels duty-free and all of the good's value is considered to be North American.[130] Regardless, the United States disallowed the North American value content of the engines.[131]

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124. *See* Cantin & Lowenfeld, *supra* note 3, at 380.

125. *See* Revenue Canada, Customs & Excise No. 4568-6-5/Honda(engine) (BP) (Feb. 27, 1992).

126. *See id.* Over ninety percent of the seventy-one thousand engines qualified. *See id.*

127. *See* Cantin & Lowenfeld, *supra* note 3, at 381. The agency did not officially release the figures. *See id.*

128. *See supra* notes 97-109 for discussion of CFTA rules of origin for automobiles.

129. *See* Revenue Canada, Customs and Excise No. 4568-6-5/Honda(engine) (BP)(Feb. 27, 1992).

130. *See* CFTA art. 301. The role up rule, in essence, embodies the concept that a good "originating" from the territory of the member states for purposes of the treaty need not contain only value from within the free trade area. So long as the good has undergone the requisite change in tariff classification and value added requirements, the good will be considered originating and all of its value will be considered originating. *See supra* note 109 and accompanying text (discussing roll-up and roll-down rules).

131. Anti-dumping issues and US contempt for the Japanese keiretsu method of business dealing also clouded this Honda controversy. "The Internal Revenue Service has beefed up its scrutiny of transfer pricing behavior by Japanese companies. The Justice [Department] is reviewing its guidelines on whether the vertically integrated Japanese auto keiretsu violate U.S. antitrust laws. . . . All of a sudden the issues of cars and transplants and keiretsu are coalescing into one." Magnusson, *supra* note 122, at 105 (quotations omitted). *See Bill Being Drafted on Japan's Treatment of U.S. Autos*, Nat'l J. Congress Daily, Oct. 15, 1991. "The auditors said Honda offered cars for sale to consumers in the United States at less than the cost of manufacture, as computed by the Customs Service." Robert Pear, *U.S. Says Honda Skirted Customs Fees*, N.Y. Times, June 17, 1991, at D1.

While United States officials have disallowed the American content of Canadian automobiles, they simultaneously have tried to convince Europeans that the Honda Accords made in Ohio are American and should not count against European Community quotas on Japanese imports. *See* Magnusson, *supra* note 122, at 105.

Ironically, the Customs Service found that the engines did not originate in the United States for purposes of the CFTA.[132] As a result, pursuant to the roll-down rule,[133] the Customs Service considered the engines to be entirely *non-originating* and to be devoid of North American value.[134] Consequently, the Civics had less than 46 percent of overall North American content.[135] Customs then billed Honda for $17 million retroactively, representing a 2.5 percent tariff on Civics shipped between January 1, 1989,[136] the effective date of the CFTA, and March 1, 1990.[137] More important than the economic effect on Honda, however, are the decision's serious political repercussions.[138]

The technical underpinnings for the Customs Service decision deserve brief consideration. First, the Customs Service held that since there was no change in tariff classification from the transformation of the engine subcomponents into the engine, the rule applicable to situations in which there was no change in tariff classification should apply.[139] Application

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132. Customs auditors found only $51.75 worth of U.S. parts and raw materials in the Honda engines made in Ohio, and found that more than $700 came from suppliers in Japan or transplant parts makers, wholly or partially owned by Honda. *See id.*

133. *See supra* note 109 and accompanying text.

134. *See* Cantin & Lowenfeld, *supra* note 3, at 381. "Customs regarded the engines sent from Ohio to Ontario as not meeting the 50 percent requirement and, under the roll-down rule, Customs therefore treated the engines as having zero North American content." *Id.*

135. *See id.* at 382. According to customs auditors, the roll-up rule allows vertically integrated companies such as Honda to manipulate the value calculation process. *See* Magnusson, *supra* note 122, at 105. According to one auditor, "it is possible, with some extraordinary planning, to have a car with less than 50 percent North American content become 100 percent North American on paper." *Id.*

Honda certified that $3,350 worth of materials came from North America, but the Customs Service said $1,085 of this amount represented 'foreign costs.' Customs concluded that at least 62 percent of the materials used to produce the Civics—$3,760 of a total of $6,025—originated outside North America. *See* Pear, *supra* note 131, at D1.

According to Honda's own accounting, the biggest item of local content added in the engine plant was the depreciation of the factory's equipment. *See* Magnusson, *supra* note 122, at 105. Customs charged that most of this should not have been included because it was imported from Japan. *See id.* "[I]n capital-intensive auto manufacturing, to what country do auditors attribute the value added by machinery, especially if the machinery is from Japan?" *Id.*

136. *See* Cantin & Lowenfeld, *supra* note 3, at 380.

137. *Id.* at 381.

138. *See id.* at 383.

> [D]ecisions about . . . which general expenses are "reasonably allocable" to production depend on how the decision maker views the object of the inquiry. If the object is to make sure no one 'gets away with anything,' the burden of persuasion will be on the manufacturer trying to qualify for duty-free treatment; if, on the other hand, the object of the inquiry is to smooth the way for free trade between the treaty partners, the same data, viewed against an incomplete or ambiguous text, may well lead to a different result.

Id.

139. The agreement treats some goods as originating where a tariff change has not occurred, but uses a more stringent value definition than otherwise applicable. *See* CFTA "[G]oods . . . shall be considered . . . as goods originating in the territory of the Party if . . . the value of materials originating in the territory . . . plus the *direct cost of*

of this rule resulted in a finding that only the direct costs of *assembly* in the United States would be included; the Customs Service excluded direct costs of *processing*.[140]

In coming to this conclusion, however, the Customs Service applied the wrong rule.[141] There had, in fact, been a change in tariff classification.[142] Therefore, Customs should have applied the rule allowing processing costs, rather than the rule restricted to assembly costs.

Second, the Customs Service held that even under the test for goods in which there is a change in classification, the costs "reasonably allocated to the production of goods" do not include costs from the casting and machining of the engine components.[143] According to Customs, costs may be reasonably allocated only if they result directly from the production of goods.[144] However, since the definitions section to the rule indicates that "the cost of energy, fuel, dies, molds, [and] tooling" should be reasonably allocated to the costs of production, "casting and machining" costs should be included.[145]

Finally, the Customs Service held that "the costs directly incurred, or that can reasonably be allocated to, the production of goods"[146] would not include any costs that were not direct costs.[147] Thus, any costs claimed by Honda that the Customs Service did not consider to be direct costs could not be allocated to the production of the engines.[148] Honda had argued, to the contrary, that in addition to *direct* costs, other costs should be included if they were reasonably allocated to the production of goods.[149]

From the perspective of the panel decision in *G.M.-Suzuki*, Honda's view is correct.[150] The costs of assembling the engine should be included

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assembling the goods . . .constitute[s] not less than 50 percent of the value of the goods when exported . . . ." *Id.* (emphasis added).

Where there is a change to heading 8407 from any other heading, direct costs of processing should be included in addition to direct costs of assembling. *See* CFTA ch. XVI, para. 3; *See also* CFTA ch. III, rules annex. These include costs of labor, inspection, energy, engineering, rent, and royalties. *See id.*

140. *See* U.S. Customs Service, Memorandum HQ 000160 (Feb. 27, 1992).

141. Cantin & Lowenfeld, *supra* note 3, at 381.

142. The transformation was from the head and block, 8409.91 of the Harmonized System, to engine, 8407.34 of the Harmonized System. *Id.*

143. U.S. Customs Memorandum 089427, at 3 (Dec. 9, 1991); U.S. Customs Service, Memorandum HQ 000164 (Apr. 30, 1992).

144. *See* id.

145. According to the American Heritage Dictionary of the English Language, 'tooling' means "[w]ork or ornamentation done with tools." 'Machining' means "[t]o cut, shape, or finish by machine." Machining obviously is merely a specific form of tooling.

146. HQ 000160, Feb. 27, 1992.

147. Direct costs include all costs that are incorporated directly into the thing manufactured. Indirect costs, to the contrary, are costs not part of the production of goods. These latter costs would, for instance, include administrative expenses.

148. Cantin & Lowenfeld, *supra* note 3, at 382.

149. *See id.*

150. *See supra* Part II.A.1.

because they are intrinsically related to the production of the goods. They are not indirectly related, for example, like office space overhead.

Thus, the Customs Service in the Honda decision misjudged the dividing line between included and excluded costs. Inclusion should turn on the composition of the product, not on the phraseology of specifically included or excluded items.

B. *Extreme Ramifications of Unguided Value-Added Determinations*

The consequences of the Honda controversy spread far beyond the parties directly involved.[151] The controversy thwarted foreign investment and enraged Canadian trade representatives.[152]

As a result of the decision, foreign investors were less likely to devote their resources to development in the free trade area. Investors found the rules of origin to be unpredictable and to create an unstable investment climate.[153] Indeed, the Treasury Department never issued regulations on value content measurement.[154] Because the rules of origin were framed as general principles, producers' reliance on them would have required systematic prior elaboration. Moreover, complying with a Customs Service audit incurred excessive expenses.[155] In the Honda case, for example, the United States audit involved more than one hundred Honda employees who spent eleven thousand hours providing information and meeting with Customs Service officials.[156]

In addition, the Canadian trade officials became outraged.[157] They feared that if third-country manufacturers could not benefit from the CFTA when assembly operations were in Canada, the manufacturers would relocate their operations to the United States.[158] Commentators have captured the essence of the controversy in posing the following rhetorical questions: "Did the United States want to collect the 2.5 percent duty on Hondas coming from Canada . . . ? Or did it want to encourage assembly operations in the United States rather than in Canada?"[159] In response to the Honda decision, Canada even invoked Chapter Eighteen of the CFTA to appeal the decision to a dispute resolution panel,[160]

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151. *See supra* Part II.C.

152. *See id.*

153. *See id.*

154. *See* Magnusson, *supra* note 122, at 105.

155. The Canadian audits were more speedy and professional. *See id.*

156. *See U.S. Customs Audit Biased, Honda says*, Toronto Star, Oct. 16, 1991, at D5 (Reuters byline).

157. *See* Cantin & Lowenfeld *supra* note 3, at 385.

158. *See id.*

159. *Id.*

160. *See* Bernard Simon, *Canada Seeks End to Car Content Dispute*, Fin. Times, Jan. 8, 1992, at I3; *Canada Requests FTA Dispute Panel on Treatment of Non-mortgage Interest*, 9 Int'l Trade Rep. (BNA) 67, Jan. 8, 1992. One of the subissues to the dispute was whether regional content should include non-mortgage interest. *See id.* The United States Customs took the position that only interest related to a mortgage can be included

although the panel never convened.[161]

The value-added difficulties of the Honda controversy reduced the desirability of the CFTA as an option for importers.[162] Since fostering importers' antipathy toward the agreement would contravene the agreement's goals and would thwart the development of economies of scale, NAFTA's success largely will depend on whether it has improved the rules to foster investment in the free trade area.

III. NAFTA'S RULES OF ORIGIN FOR AUTOMOBILES

Partly to resolve the Honda dispute, the United States and Canada agreed to clarify NAFTA's rules of origin and to resolve the existing disputes according to the new rules.[163] NAFTA has alleviated some of CFTA's difficulties.[164]

Hybrid automobile and automobiles parts must qualify under Article 401(b) to receive duty-free treatment.[165] Under this article, goods also must meet a change in tariff classification test and a minimum threshold percentage of regional value content, although the details are somewhat different from those of the CFTA.[166] The Honda scenario must be

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under the rules of origin. *See id.* The Canadian officials also included interest paid in relation to land, equipment, and buildings used in the production of goods. *See id.*

Under the CFTA, the parties would have 30 days from the date of the formal request to form the panel that would be composed of two members of each country and a fifth chosen jointly. The panel would then have 120 days to issue a final report.

161. Commentators thought that if the Honda controversy would have gone to the panel, that a resolution favorable to Honda would have resulted. *See* Cantin & Lowenfeld, *supra* note 3, at 385.

162. *See* Sheppard, *supra* note 106; *Implementation of the U.S.-Canada Free Trade Agreement*, U.S. General Accounting Office, at 28-31 (GAO/GGD-93-21, 1992). In addition, whereas Revenue Canada had moderated the impact of a strict accounting approach by adopting a Generally Accepted Accounting Principle approach, the United States took a narrower view. *See* Ralph H. Sheppard, *supra* note 106. The barriers posed by these accounting requirements may be insurmountable.

163. Cantin & Lowenfeld, *supra* note 3, at 385.

164. There are a total of four alternative standards under NAFTA. First, NAFTA allows duty free treatment for a good wholly produced in the territory of the parties. *See* NAFTA art. 401(a). This category largely refers to agricultural, livestock, and mineral products. *See* NAFTA art. 415(a)-(j). Second, the Agreement allows duty free treatment for a good that undergoes a change in tariff classification according to the Harmonized System. *See* NAFTA arts. 401(b), 413(a). With regard to automobiles, the additional regional value content (RVC) minimum threshold percentage requirements of art. 403 generally must be met within this category. Third, if unassembled components of a good do not undergo a change in tariff classification because the component parts and the finished product are classified in the same category, the good may qualify for duty free treatment if the value of originating materials plus the direct costs of assembly meet the stated value-content requirement. *See* NAFTA art. 401(d). Each of these preceding methods also existed under the CFTA. NAFTA adds a fourth 'de minimis' test which allows duty-free treatment if a good contains no more than 7 percent 'non originating' material. *See* NAFTA art. 405. The CFTA had been criticized for disallowing qualification where an importer product had minimal third country content, but no change in classification. *See* Sheppard, *supra* note 106, at 20.

165. *See id.*

166. *See* NAFTA arts. 403, 402(5)(d)(i), 402(5)(d)(ii), 402(5)(a), 402(5)(c). Auto-

reevaluated under the new provisions.

A. *NAFTA'S Reformation of the CFTA's Value-Added Component to the Automobile Rules of Origin*

One controversial aspect of the CFTA automotive provisions related to the type of value that should be considered in calculating the value-added requirement.[167] NAFTA adopted a broader view of this requirement than the CFTA,[168] defining "production" as "growing, mining, harvesting, fishing, trapping, hunting, manufacturing, processing or assembling a good."[169] The inclusion of manufacturing, processing, or assembling within the "production" definition avoids the Honda-type controversy over what types of costs should be considered. The broader definition is a great improvement over the hair-splitting CFTA provisions.[170]

NAFTA also increased the value-added requirement of the rules of origin for automobiles.[171] Workers and, therefore, congressional representatives have been concerned about protecting North American employment opportunities in automotive parts production.[172] The agreement, therefore, endeavors to encourage foreign companies to import fewer parts and to produce more parts in North American facilities.[173] The value-added requirements have been increased to prevent non-NAFTA producers from using Mexico as a "platform" from which to ship their goods to the territory of the other members duty-free.[174]

The threshold of 62.5 percent[175] was a compromise. During the

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mobiles must be assessed according to the net cost valuation method. This method includes most direct costs incurred in a member country. This is similar to the CFTA valuation method. However, NAFTA allows more direct costs and alleviates the distinctions between assembly costs and processing costs, and between 'direct' and 'reasonably allocated' costs. *See* Cantin & Lowenfeld, *supra* note 3, at 386-88.

167. *See supra* Part II.

168. The resolution of the issue of what type of costs would be included North American value from the finishing of the engine Civic in Ohio, in the *Honda* dispute, would be favorable to Honda.

169. NAFTA art. 415.

170. *See supra* Part II.A.

171. Under the CFTA rules of origin, a car or component required, in addition to a change in tariff classification, 50 percent value added in one party before it could travel duty-free to the other. By 2002, NAFTA will have increased the percentage of value required to be added in North America to 62.5 percent.

172. Everett, *supra* note 17, at 1E.

173. *See id.* In the long run, Mexico may lose some parts production jobs to United States and Canadian competitors. Under NAFTA, Mexico must abandon the rules which it currently maintains that require foreign producers of automobiles in Mexico to use Mexican parts. Once NAFTA is implemented, producers of cars in Mexico may also use parts from Canada and the United States. *See id.*

174. *See id.* "[R]ules that require greater use of North American-made parts in any vehicle traded duty-free among the three countries . . . should limit Japanese imports and also could protect jobs in the huge U.S. auto parts industry." *Id.*

175. The increases will occur in two steps over an eight year period. From January 1, 1994 through the January 1, 1998, the percentage will remain at 50 percent. *See* NAFTA

NAFTA negotiations, American manufacturers sought a high regional value content to protect their competition from non-NAFTA vehicles.[176] Canada accepted the increase in exchange for a more inclusive value definition.[177] Mexico had wanted a lower threshold to encourage investment in Mexico by non-NAFTA automobile companies who could sell their products duty-free in the United States or Canada.[178] The increased value-added threshold has the greatest potential to thwart investment in the free trade area. It has engendered more cries of protectionism than any other aspect of the rules of origin for automobiles.[179]

To prevent the increased value threshold from diverting investment, the rules should be interpreted consistently. In the end, it is not clear whether the increase in the percent of North American value required will encourage or discourage Japanese investment in NAFTA.[180] If read consistently, the rules of origin may become the decisive factor in favor of investment.

To benefit producers in Honda's position, NAFTA also abandoned the CFTA's roll-up/roll-down rule in the Auto Sector provisions.[181] In

art. 403(5)(a). The percentage will then be 56 percent for motor vehicles and some parts, including engines, until January 1, 2002, when it rises to 62.5 percent. NAFTA art. 403(5)(a).

Some commentators have noted that initially, auto producers will get a big break with regard to the rules of origin. Under the first four years, the percentage of value required to be added in North America will remain at 50 percent, but will include costs that were not allowable under the CFTA. *See* Eric Hartman, *The Northeast-Midwest Congressional Institute Press Briefing*, Fed. News, Dec. 3, 1992, *available in* LEXIS, NEWS Library, CRNWS File.

176. The Association of the Bar of the City of New York, Report On the North American Free Trade Agreement 10, Oct. 28, 1993 [hereinafter "Bar Report"]. Japanese companies and their transplant operations in North America seem to be the principal target of the more protectionist Domestic Content standards. *See id. See also* Hearing on NAFTA and the Public Sector (Rep. Conyers) (July 27, 1993). "[At a 62.5 percent value requirement], Japanese auto companies would be allowed to use Mexico and Canada as platforms to achieve further penetration of the United States market. Cars assembled in Mexico and Canada by Japanese and other auto manufacturers would be allowed to enter the United States duty free, even if a substantial portion of the parts in those vehicles are imported form outside of North Americas." *Id.*

177. *See* Kelly McParland, *Election Result Could Hit Trade Deals*, Fin. Post, Sept. 2, 1993, at 7; *see also supra* note 170 and accompanying text (discussing the more inclusive value definition).

178. *See* Bar Report, *supra* note 76, at 10. Mexico must significantly modify its Auto Decree to participate in NAFTA. *See* NAFTA app. 300-A.2. For example, Mexico must change the conditions required to qualify as a national supplier of autoparts or an enterprise of the autoparts industry. *See id.* Also, Mexico must phase out its value-added rules for the percentage of parts that must be purchased from national parts producers and the rules requiring the level of export goods to meet the amount of goods imported into Mexico. *See id.*

179. *See supra* note 17 and accompanying text.

180. *Compare* Damian Fraser, *Survey of World Car Industry*, Fin. Times, Sept. 9, 1993, at XI ("VW and Nissan are having to persuade German and Japanese parts suppliers to set up in Mexico so as to comply."), *with* Taylor, *supra* note 17, at 23 (suggesting the high North American content requirement would discourage relocation of Japanese vehicle parts production).

181. *See* Bar Report, *supra* note 176, at 16.

Honda, the Customs Service calculated the value-added to the engine in the United States to be less than 50 percent, and rolled down the value of the engine to zero in calculating the North American value of the Canadian Civic.[182] Even though the trade authorities determined that much of each car's value was added in the United States, they gave the car no credit for the engine's value. In contrast, under NAFTA's rules of origin for automobiles, the value of materials considered nonoriginating is the actual value of the materials, without any "rolling" effects.[183] Thus, the value of nonoriginating components that are incorporated into larger assemblies would be traced forward from the value at importation through each subsequent value-added stage until NAFTA preference is claimed.[184] Thus, the value of a nonoriginating material always will be deducted from the value of a sub-component.[185]

These value definition and rolling changes will allow the disputed Hondas to qualify for duty-free treatment. NAFTA's rules of origin expand the range of costs included under the net cost method of determination and would allow the value of the engine to surpass a 50 percent North American value requirement.[186] The value of the engine attributable to North American value would be the actual amount of value incorporated within it.[187] "Th[e] product will be strictly accounted for as it goes through the production process so that if an engine has only 50 percent North American content, that's all that it will be credited for when included in a finished vehicle."[188] This adds enough value to the 46 percent North American engineless Civic to qualify the car for duty-

182. *See supra* notes 133-35 and accompanying text. In the Honda case, the role-down aspect of the rule resulted in a zero value added determination for the United States engine block. *See id.* If the role-down rule were not in effect, the North American value added in the engine may have allowed the Civic to qualify for duty-free treatment in shipment to the United States.

183. *See* NAFTA art. 403.

> [T]he value of non-originating materials used by the producer in the production of the good shall be the sum of the values of non-originating materials, determined [by transaction value if available] at the time the non-originating materials are received by the first person in the territory of a Party who takes title to them, that are imported from outside the territories of the Parties . . . and that are used in the production of the good or that are used in the production of any material used in the production of the good.

Id.

184. *See Automotive Industries Will Gain in the Long Term*, 3 Mexico Trade & L. Rep. No. 7, July 1, 1993, *available in* LEXIS, NEWS Library, CURNWS File.

185. Although commentators have suggested that the Ohio engine would be considered entirely North American under the agreement, *see* Lowenfeld & Cantin, *supra* note 3, at 388, this conclusion appears incorrect.

186. Although eventually, the value requirement for automobiles will be at sixty-two and one-half percent, the *Honda* controversy is to be resolved under the terms of the agreement as they initially apply.

187. There is no roll-up rule under the agreement. *See supra* note 183 and accompanying text. Therefore, in no event would the engine be considered to be one hundred percent North American.

188. Hartman, *supra* note 175, at *1.

free treatment.[189]

B. *Improvement*

Because the actual percentage of value added in the territories of the parties will be used in NAFTA value determinations, interpreting value-added requirements consistently may be more important now than under previous agreement. Under the CFTA, a general determination that a component was either more or less than 50 percent originating was adequate to assess whether the component had 100 percent or no North American value. Under NAFTA, to the contrary, a precise determination must be made. To this end, it is as important now as ever for the Customs Service to work with the officials of the other member states to arrive at consistent interpretations of the rules of origin.

1. Preliminary Recourse: NAFTA's Working Groups

NAFTA provides for working groups to harmonize the interpretations of rules of origin and to ensure that the interpretations are in accord with the principles of the agreement.[190] The United States should comply with NAFTA's mandate to participate in the groups.

The United States should not let NAFTA's rules of origin working group mandates fall by the wayside, as did similar CFTA working groups. The CFTA mandated the creation of a working group to resolve antidumping disputes.[191] Yet, the United States refused to meet with Canada to discuss the harmonization of anti-dumping policies.[192] The apparent acts of bad faith under the CFTA engendered significant Canadian contempt and distrust. Similarly, for the United States independently to interpret NAFTA would "be an error-filled chore rife with interpretational disagreements respecting tariff classification"[193] and value-added determinations.[194] It would be a mistake for the United States to refuse to cooperate this time around.

NAFTA has established a working group on rules of origin.[195] The

189. Most commentators believe that Honda will be relieved of the duties of the original customs audit. *See id.*

190. NAFTA establishes a Working Group on Rules of Origin, comprising representatives of each party to ensure the effective implementation of the rules of origin. *See* NAFTA art. 513. The Working Group must meet at least four times per year and at the request of any Party. *Id.* The Customs Subgroup also must meet four times per year. *Id.* The representatives of this group must "endeavor to agree" on "the uniform interpretation, application and administration" of the rules of origin. *Id.* Although the United States had not complied with CFTA working groups, it would benefit from compliance with NAFTA's institutions. *See infra* Part III.

191. *See* CFTA art. 1907, para. 1(b) (creating working group on antidumping duties).

192. Later, under the NAFTA, the United States insisted on dropping the provision for the creation of the working group, to avoid the preexisting obligation.

193. Robert T. Givens & Rayburn Berry, *Customs Enforcement and the NAFTA*, 24 St. Mary's L.J. 903, 926-27 (1993).

194. *See supra* Part I.B.3.

195. *See* NAFTA art. 513.

purpose of the group is to ensure the effective implementation of the rules of origin.[196] It is designed to include representatives of each party and to meet at least four times each year.[197] In addition, NAFTA has established a customs subgroup on rules of origin, the purpose of which is to "endeavor to agree" on "the uniform interpretation, application and administration" of the rules of origin.[198]

The United States should participate with the other member states to agree on the proper application of the rules of origin. Under the CFTA, the United States failed to put forth any clear guidelines for interpretation, correct or not.[199] Moreover, in *G.M.-Suzuki* the Chapter Eighteen dispute resolution panel achieved a better, more holistic, interpretation of what type of value should be considered to be originating than had the United States Customs Service.[200] The United States should help to arrive at a uniform understanding *before* it becomes necessary to employ the dispute resolution panels to resolve particular controversies. Uniform understanding and interpretation will encourage the foreign investment envisioned by NAFTA and save traders the unnecessary and prohibitive costs of litigating these issues.[201] To these ends, the United States should follow NAFTA's provisions for the working groups on rules of origin.

2. GATT Committees

One remaining concern to the United States would be that without a formal GATT prohibition of unfair preferential rules of origin, other free trade groups, especially the European Community, might continue to use origin rules unfairly to restrict the importation of NAFTA products.[202] To avoid this result, the member states should pursue the GATT adoption of such prohibitions. Indeed, the United States has sought this objective when in the past its industries were threatened by the European Community rules of origin.[203] Fortunately, GATT's newly created "Rule of Origin Committee" allows its members to agree to prohibit the misuse of rules of origin.[204]

GATT members should extend the requirements for non-preferential rules of origin to preferential rules. Understandably, policy makers may

196. *See id.*
197. *See id.*
198. *See id.*
199. *See supra* Part II.B.
200. *See supra* Part II.A.1.
201. *See id.* In addition, "effective coordination among the NAFTA parties for consistent customs valuation will be necessary since any significant variation in methodology could result in 'shopping' for the most favorable border or port." Hartman, *supra* note 175, at *1.
202. Steinberg, *supra* note 101, at 330.
203. *See id.*
204. *See* Uruguay GATT, *supra* note 25, D.1-14 art. 4(1); Steinberg, *supra* note 2, at n.161 and accompanying text.

refuse unilaterally to improve NAFTA's rules of origin while other free trade agreements use unfair interpretations. However, GATT allows members to mandate fair use of rules of origin universally—in all free trade areas and customs unions. To achieve NAFTA's goals, the United States should harmonize its interpretation of the rules of origin with the goals of free trade through both NAFTA and GATT.

CONCLUSION

Although NAFTA has appreciably improved upon CFTA's rules of origin for automobiles, the most dangerous flaw remains—the value-added component of the test. This rule is by its nature highly subjective. Moreover, political sensitivity to trade issues exacerbates matters. Therefore, NAFTA member states must harmonize the rules.

NAFTA mandates that member states unite to develop NAFTA rules of origin interpretative guidelines. The member states should seize the opportunity to align NAFTA's rules of origin interpretations with the principles of GATT and ban the misuse of rules of origin in non-preferential settings. Extending the ban to NAFTA will improve political relations and increase foreign investment. Moreover, if adopted through GATT measures, the prohibition on misuse of rules of origin would increase the opportunities of United States businesses to trade in the European Community. In sum, although rules of origin of free trade agreements necessarily bar some products from duty-free entry, well-designed rules will afford free trade area member states substantial long term benefits.